Available online at www.sciencedirect.com
ScienceDirect
Procedia - Social and Behavioral Sciences 92 (2013) 784 – 788
Procedia
Social and Behavioral Sciences

Lumen International Conference Logos Universality Mentality Education Novelty (LUMEN 2013)

The Theoretical Foundation of Goodwill - A Chronological Overview

Raluca Valeria Ratiu[a] *, Adriana Tiron Tudor[b]

[a] *Babes-Bolyai University, Faculty of Economics and Business Administration, Department of Audit and Accounting, Theodor Mihali 58-60, Cluj-Napoca, 400591, Romania*
[b] *Babes-Bolyai University, Faculty of Economics and Business Administration, Department of Audit and Accounting, Theodor Mihali 58-60, Cluj-Napoca, 400591, Romania*

Abstract

In this article we discuss the concept of goodwill as it was perceived by prominent academics and practitioners of the 20th century in their theories on goodwill. The purpose of our study is to offer a complete overview of the theoretical background of goodwill, a concept which has been puzzling and debated for more than a century. We engage in a critical analysis of three theories on goodwill which passed the test of time, and are still discussed upon, today: P.D. Leake's (1921) "The Super-Profit Theory"; Nelson's (1953); "Momentum Theory of Goodwill"; and Lonergan's (1995) analysis of goodwill divided into subcategories. Further, we identify and synthesize the literature for favorable opinions with regard to these theories as well as ardent critics which were given by other academics and practitioners. Throughout the article we constantly advance our own opinion and apply critical thinking in order to obtain a comprehensive chronological and qualitative study on the theoretical foundation of goodwill. The conclusion we reach following our study is that the concept of goodwill evolved in time, but that goodwill remains a thorny issue for which a final consensus remains yet to be reached.

Keywords: goodwill; goodwill theory; parent company theory; economic entity theory;

* Corresponding author. Tel.: +40-264-418-652; fax: +40-264-412-570.
E-mail address: raluca.ratiu@econ.ubbcluj.ro

doi:10.1016/j.sbspro.2013.08.755

1. Introduction and motivation

The topic for the following study arose from the need to clarify how goodwill has fit in the accounting theories landscape throughout the ages. Cluskey et al. (2007) consider that knowledge of accounting theory in general is required by both academics and professionals, because accounting theory offers the necessary framework in which both groups should operate. By accounting theory Devine (1985) understands an "entire complex of logical rules, primitive terms, and semantic rules of correspondence, interpretations, definitions, and theorems, necessary to explain behavioral and physical observations".

The concept of goodwill is used interdisciplinary in accounting, economy, law, marketing, sociology or human resources. For the purpose of this article we will discuss the accounting concept of goodwill which can be defined using the Glossary in the International Financial Reporting Standards (IFRSs) as "an asset representing the future economic benefits arising from other assets acquired in a business combination that are not individually identified and separately recognized".

Goodwill is one of the most controversial assets in the balance sheet and the debate around it has been ongoing from the nineteenth century until today, whether it was about how the term was defined, recognized or accounted for in the financial situations. Hughes (1982), the author who wrote the most comprehensive study of the history of accounting goodwill, admits that the debate around goodwill was possible, because even though the origin of goodwill can be determined, its nature will always be prone to interpretation. This is the main reason why many authors have defined goodwill, a chronological review of the definitions can be found in Courtis (1983) or Ratiu and Tiron (2012), but very few authors have attempted to build a theory which best integrates the concept: Leake (1921), Nelson (1953) and Lonergan (1995).

The remainder of the paper is organized as follows: in Section 2. we review prior literature related to goodwill theories and describe the research methodology we used for our article, in Section 3. we discuss the theories which are most used in relation to goodwill and finally, in Section 4. we present our concluding remarks.

2. Prior literature and research methodology

Numerous authors have given accounting theory the characteristics of a conceptual framework, comprised of accounting principles which have the role to guide and inform academics, researchers as well as professionals, Cluskey (2007). The accounting theories which we analyze in the next section present this main characteristic, because predominantly all of them introduce a new, different way of regarding goodwill.

The need for a widely accepted and comprehensive theory of goodwill has been discussed by authors ever since the early 1900s. Kaner (1937) considers that up until then the existing theories were built merely on guesswork, rather than science. In his book "A New Theory of Goodwill" he seeks not to find this new theory- as one might be tempted to understand from the title-, but rather to broadcast the need for a goodwill theory built on "scientific knowledge obtained from analysis, research and classification" as he declares himself. Kaner (1937) strongly argues the Super-Profit theory which he denies is suitable for its purpose and even calls it unscientific. But the literature is at times favorable to this theory as, three decades later, Carsberg (1966) highlights the merit of P.D. Leake for developing the Super-Profit theory of goodwill.

Regional studies of goodwill and the underlying theories and policies behind it are numerous in the literature. Nobes (1992) is among the first authors in contemporary literature to conduct a study of goodwill in the particular setting of UK and his results demonstrate that certain cyclicity was observed with connection to the standards regulating goodwill. Ding et al. (2008) study the setting of four different countries with regard to the shareholder/stakeholder models which they relate to the balance sheet theory in order to explain the evolution of goodwill in these countries. Garcia (2012) follows into the research of Ding et al. (2008) to extend the analysis to the exotic setting of Japan. Results show that Japanese views on goodwill closely resemble those in the European countries.

Bloom (2008) reviews the first three theories which we analyze in this article in order to find historical arguments in favor or against amortization.

The research methodology we found to be most adequate for this paper is a thorough content analysis of the literature. We first identify the main theories which explain the concept of goodwill, and then select those theories which were cited and discussed by other authors, because this way we could confirm that these theories stood the test of time. We carefully analyze these theories and present them using a personal interpretation.

3. Prominent theories of goodwill

3.1. The Super-Profit Theory of goodwill

P.D. Leake (1921) defines goodwill as "the right which grows out of all kinds of past effort in seeking profit, increase of value or other advantage". In an attempt to find a valuation method for goodwill he advances the theory of the super-profits of goodwill. By super-profit he means "the amount by which revenue, increase of value, or other advantage received exceeds any and all economic expenditure incidental to its production". Leake claims that the entity acquiring the goodwill is paying for a share of the next year's super-profits. He suggests that goodwill should be written-off in the period that the super-profits are expected to be earned. He even suggests that the super-profits are a given because the amount paid for goodwill secures, he says, "an extra profitable opening for the employment of capital".

What Leake actually proposes is the writing off of goodwill against the purchaser's future earnings, for a certain period of time in which these earnings are supposed to arise. After all of the acquired goodwill is written off, Leake does not question that internally generated goodwill may appear and support future super-profits, but he advises against the recognition of this type of goodwill in the balance sheets. Having now access to review all the changes which goodwill has gone through in its history, we notice that Leake's theory is the precursor of the amortization of goodwill practice and it was a first solution to the never ending problem of the accounting treatment of goodwill.

Paton and Littleton (1940) support Leake's theory and they accept that goodwill is merely an advanced payment for part of the income which will be earned in the future. They continue Leake's rationale and explain that goodwill must be written off against future earnings, in order for the real earnings not attributable to goodwill to be measured.

Carsberg (1966) tells about the first time Leake read his theory in 1914 to the Liechesters Chartered Accountants Student Society. He arose interest from the audience with this new theory and generated an increasing stream of writings on accounting subjects. After he makes a thorough analysis of Leake's work, Carsberg (1966) reaches the conclusion that it may indeed be a refined collection of ideas which were discussed in the academic and accounting professional environment at the time, which Leake disseminates in his book. This does not, in any way, diminish the merit of Leake or the importance of his work.

Kaner (1937) is an ardent critic of the Super-Profit theory and he dedicates an entire chapter of his book to discuss it. He argues that because super-profits can never be permanent Leake's theory "must be specious". He says that this valuation method is flawed because it doesn't address all types of goodwill he mentions. He believes that because goodwill is influenced by its typology, by internal factors pertaining to the type of business it derives from and other external factors, a simple method of valuation is not feasible, nor is it scientific, but relies more on assumptions. Our opinion on the critiques Kaner brings forward is that the valuation of goodwill must indeed be customized, but that Leake's theory does not impede this. We agree that the theory may be somewhat elusive on how exactly the evaluation must be made, but as for the treatment it proposes, it precluded amortization which was a common practice for IFRS adopters until 2005 and is still used in many other countries today.

3.2. The Momentum Theory of goodwill

In 1953 Robert Nelson advances the Momentum Theory of goodwill which advances the hypothesis that “a businessman purchases a promotional push instead of an Annuity [making reference to the Annuities proposed by Leake] and that the “push” dissipates like momentum”. Nelson clearly defines what the goodwill of a company consists of: “goodwill, customer lists, and organization costs, costs of development, trade names, secret processes, patents, copyrights, licenses, franchises, superior earning power, and going value”. The “push” is only explained by Nelson in connection to marketing, but Bloom (2008) finds more advantages the push can also be connected to: keeping the old personnel and exiting administrative organization, the benefit of having telecommunication connections in place, or even certain authorizations needed for the business to function.

If at first Nelson’s and Leake’s theory appear to be similar, because they both propose amortization against future income, there are major differences between the two. First, Nelson does not link the existence of goodwill to the necessity of future super-profits. Rather, he considers that the momentum one gains from acquiring the goodwill of an existing business resides more in the time one saves from starting a new business from scratch and creating all these advantages the existing business brings along. Second, even though a company may have profits, the existence of super-profits is not essential in Nelson’s theory. The only proof a prospective client needs, according to Nelson, in order to buy an existing business is that a marketing, promotional or other push exists, and thus it is more profitable to buy an existing business instead of building it from the beginning. Third, because this momentum would, in theory, last longer than the existence of super-profits, Nelson proposes that the initial investment would be amortized against income in a period of two to ten years, depending on how much the push lasts.

For the opponents of Leake’s Super-Profit Theory, Nelson’s alternative theory seems to be a good alternative. This alternative that does not link the existence of goodwill to future super-profits, but instead acknowledges the momentum which results from the advantage of not spending resources worth more than something which can be bought: i.e. the going concern of an existing business and the presence in the market.

Empirical evidence in support of Nelson’s theory is provided by Chauvin and Hirschey (1994). They findings indicate that there is a positive association between goodwill and post-acquisition advertising, which proves Nelson’s thesis that goodwill is value relevant.

Nelson’s theory has not attracted much appraisal or criticism in the literature, and even though it is often cited in empirical papers, we cannot undoubtedly say that it represents that one theory of goodwill which researchers are striving to find.

3.3. Goodwill analyzed through its components

The idea to analyze goodwill through its components, which Lonergan (1995) advances, is not innovative, but he is the first author to build a theory around it. The reason behind the idea to distinguish between goodwill’s components is that Lonergan aims to find a non-arbitrary amortization period for goodwill. He considers that knowing exactly what the elements aggregated under goodwill are is decisive to find the correct amortization period. Lonergan’s theory is consistent with the bottom-up perspective, according to which attention is given to goodwill’s components rather than its measurement. The theory meets the requirements of the IFRS 3, which was a year later adopted by the SFAS 141 to disclose the elements that constitute goodwill in the notes of the financial situations.

Bloom (2008) borrows Lonergan’s theory, and presents the constituents of goodwill, with some adaptation. We choose to present Bloom’s list because we find it brings added value to Lonergan’s. According to this improved list, goodwill consists of: various “synergy effects”, “the quality of the marketing team and general market expertise”, “consumer loyalty”, “economies of scale within the organization its self or resulting from acquisition”, “ a well-developed distribution network”, “benefits arising from location in a particular area”, "possession of a monopoly in one or more areas of operation", "know-how and technical skills vested in individual executives or teams within the organization", "innovative use of technology". In order to reach his initial purpose to find the right amortization period for goodwill according to its components, Lonergan creates four categories into which each component might fall under: short term, of 0 to 3 years; medium term, from 3 to 7 years; long term, from 7 to 10 years; and very long term, from 10 to 20 years. Allocating each of the components into one of the four categories eliminates some of the arbitrary decisions which are made when amortizing goodwill, according to Bloom (2008).

The question we pose regarding Lonergan's theory addresses its core and relates to the definition of goodwill which we cite in the introduction of this article: if all goodwill components are individually identified, and they are separately categorized for amortization, then isn't the whole concept of goodwill useless and bound to disappear? If that is the result from applying this theory of goodwill, Lonergan certainly is approved by Tearney (1981), who believes that, to the extent possible, goodwill should be annulled, and any excess payment made above the value of the assets acquired should be treated regarding its individual components.

4. Conclusion

Alphonse Karr (1849) once said that "the more thing change, the more they stay the same". The accounting for goodwill has generated so many debates, which go back and forth, that one would be inclined to agree to his saying if they didn't go into the depth of the matter of the evolution of goodwill in theories throughout almost a century. The theories we revised in this article present goodwill from various perspectives. It makes it easier to the researcher now, to understand how goodwill evolved as a concept and why the accounting treatment for goodwill fluctuates between one option and another. When goodwill is regarded from the position to generate super-profits or to offer acquiring companies a push which supports the company in its future development, when it is divided into components until it almost disappears as a sole concept, then the choice of how to recognize it in the balance sheet, to write it off, or amortize it steadily begins to make sense. Although limited to three theories which explain the concept of goodwill, this study helps our future research of the accounting treatment of goodwill which we will analyze in a chronological matter.

References

Bloom, M. (2008) Double accounting for goodwill: A problem redefined , Routledge, United Kingdom.
Carsberg, B. (1966). The Contribution of P. D. Leake to the Theory of Goodwill Valuation, *Journal Of Accounting Research*, p.1-15.
Chauvin, K., Hirschey, M. (1993). Advertising, R&D Expenditures and the Market Value of the Firm, *Financial Management*, Vol. 22, No.4, p. 128-140.
Cluskey,G.R. Jr., Ehlen C., Rivers R. (2007). AccountingTheory:Missing in Action?, *Management Accounting Quarterly, vol. 8, No. 2.*
Courtis, J.K. (1983). Business Goodwill: Conceptual Clarification Via Accounting, Legal and Etymological Perspectives, *The Accounting Historians Journal, Vol. 10, No. 2*, p. 1-38.
Devine, C.T. (1985). Essays in Accounting Theory*, Studies in Accounting Research, AAA*, p. 15.
Ding, Y., Richard, J., Stolowy, H. (2008). Towards an understanding of the phases of goodwill accounting in four Western capitalist countries: from stakeholder model to shareholder model, *Accounting, Organizations and Society, 33*, p. 718-755.
Garcia C. (2010). A Brief History of Accounting for Goodwill in Japan and France: War, Tax and Accounting Practice, online at http://www.gakushuin.ac.jp/univ/eco/gakkai/pdf_files/keizai_ronsyuu/contents/contents2006/4801/4801garcia/4801garcia.pdf
Hughes H.P. (1982). Goodwill in Accounting, *Business Publishing Division, College of Business Administration, Georgia State University.*
Kaner, H. (1937). A New Theory of Goodwill, Sir Isaac Pitman and Sons, Ltd.
Leake, P.D. (1921). Commercial Goodwill. Its History, Value and Treatment in Accounts, Sir Isaac Pitman and Sons, Ltd.
Lonergan W. (1995). Goodwill and Bad Ideas; Fact and Fiction in the Amortisation Debate', *JASSA*
Nelson, Robert H. (1953). The Momentum Theory of Goodwill, *The Accounting Review, Vol. 28, No. 4,* p. 491-499.
Nobes, C. (1992). A Political History of Goodwill in the U.K.: An Illustration of Cyclical Standard Setting, *ABACUS, Vol. 28, No. 2*, 142-167
Paton, W.A. and Littleton, A.C. (1940). An Introduction to Corporate Accounting Standards*, American Accounting Association.*
Ratiu, R.V., Tiron-Tudor, A. (2012). The Definition of Goodwill- a Chronological Overview, *Revista Română de Statistică – Supliment Trim IV*, p. 54-60.